STATE OF MAINE

SUPREME JUDICIAL COURT
SITTING AT THE LAW COURT

LAW COURT
DOCKET NO. PUC-01-702

OFFICE OF PUBLIC ADVOCATE,
Appellant

v.

MAINE PUBLIC UTILITIES COMMISSION
and
VERIZON NEW ENGLAND, INC. d/b/a VERIZON MAINE
Appellees

BRIEF OF THE APPELLEE
MAINE PUBLIC UTILITIES COMMISSION

Peter G. Ballou
Deputy General Counsel
Bar No. 1821

Mitchell M. Tannenbaum
Acting General Counsel
Bar No. 3154

Maine Public Utilities Commission
242 State Street
18 State House Station
Augusta, Maine 04333-0018

Telephone: (207) 287-3831

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Maine PUC Orders in Other Proceedings

Statutes

Rules and Regulations

I. INTRODUCTION TO BRIEF

The Public Advocate of the State of Maine has appealed two decisions made by the Maine Public Utilities Commission (PUC or the Commission). In the first of those decisions the Commission extended and made modifications to the "alternative form of regulation" (AFOR) for Verizon Maine without conducting a revenue requirement proceeding that the appellant Public Advocate claims is required by law. In the second decision, the Commission ordered an increase to Verizon's local service rates that allowed Verizon to offset most of a statutorily required reduction in access rates (rates paid by interexchange carriers for using Verizon's local network facilities). In this brief, the Commission will establish that both decisions were lawful and made in the exercise of the Commission's sound discretion.

II. STATEMENT OF THE CASE: PROCEDURAL HISTORY

The Commission opened the proceeding now appealed by the Public Advocate in December of 1999 under the name entitled *Maine Public Utilities Commission, Investigation into Bell Atlantic-Maine and Alternate Form of Regulation,* Docket No. 99-851. The Commission issued two notices and several orders during the course of the proceeding. Those that are most important to this appeal (with the short-form names that will be used in this brief) are:

- *Notice of Investigation*, December 27, 1999
- *Order Denying OPA Request for Revenue Requirement Case*, June 20, 2000 *(Order Denying OPA Request)*
- *Further Notice of investigation*, June 26, 2000 *(FNOI)*

- *Order on Reconsideration*, August 22, 2000
- *Order*, June 25, 2001 *(2001 AFOR Order)*
- *Order Granting Requests for Reconsideration; Order Granting and Denying Modifications*, October 12, 2001 (*Order Granting/Denying Modifications)*

Because of delays in the proceeding and because the Commission determined that a number of related proceedings and events (including the 2001 access rate reduction required by 35-A M.R.S.A. § 7101-B) would occur about six months after the expiration of the initial five-year period of the AFOR, in October, 2000, the Commission extended the first phase of the AFOR for an additional six months.

The Commission held hearings on March 9 and 13, 2001 and the parties filed briefs thereafter. The Public Advocate raised the issue of whether the Commission should conduct a revenue requirement proceeding (addressed in Part VI of this brief) on at least four occasions in this proceeding: in a Motion filed on March 10, 2000 (denied by the Commission in the *Order Denying OPA Request*); in a Motion for Reconsideration of the *Order Denying OPA Request* (denied by the Commission in the *Order on Reconsideration*); in the Public Advocate's brief to the Commission; and in a Motion for Reconsideration filed after the *2001 AFOR Order* that the Commission denied in the *Order Granting/Denying Modifications*.

The Public Advocate argued that the Commission should not increase local rates to offset the access rate reduction required by statute (the issue addressed in Part VII of this brief) in his brief to the Commission and in the July 16, 2001 Motion for Reconsideration.

III. STATEMENT OF THE CASE: BACKGROUND AND CONTEXT

A. Regulation of Utility Rates: Rate of Return and Incentive Regulation

Until the last decade or so, the rates of telephone utilities in the United States were regulated under a form of regulation known as "rate of return" (ROR). Under that form of regulation, the regulatory commission (in Maine, the PUC) establishes a utility's costs and sets rates that are designed to cover those costs. One major component of cost are "expenses," which include depreciation and operating costs such as administrative costs and maintenance. The other major cost component is the cost of capital (or allowed "rate of return") – the amount of profit that the regulator establishes as necessary to attract needed capital. The return component is expressed as a percentage and is applied to the utility's "rate base," i.e., its current level of investment.

ROR regulation had been criticized as presenting inadequate, even perverse, incentives to utilities to operate efficiently. If a utility's costs exceeded its revenues for whatever reason, including inefficient management, it filed a rate case and almost always received approval for some amount of rate increase. The utility's claimed level of costs, particularly its cost of capital (an area that is quite judgmental) were subject to dispute, of course, but the incentive to file a rate case was much stronger than the incentive to control costs if costs were increasing and profits were squeezed.

During the past decade, most (about 39) states have replaced ROR regulation for their largest telephone utilities with some form of "incentive regulation." The purpose of incentive (or "alternative") regulation is to encourage efficient operations, lower costs, and ultimately lower prices than under ROR regulation. Perhaps the most important feature of incentive regulation is the "stay-out." Under a stay-out, which typically lasts for at least five years, the utility's rates are set according to a formula that are divorced from the actual costs incurred by the particular utility. The utility cannot return to the regulatory commission if its costs are too high and profits (or rate of return) too low. Similarly, the regulator agrees to refrain from initiating a rate case if it believes the utility is "overearning." This system of regulation provides a powerful incentive to the utility to operate efficiently. If it does, its profits are better than if it is not efficient. Incentive regulation regulates prices, not costs (except indirectly, through incentives) and (unless there is a "sharing" mechanism) not earnings.

When a regulatory commission establishes an incentive plan for the first time, it typically conducts a revenue requirement proceeding that establishes a cost-based "starting point" for rates under the incentive plan. Incentive plans often include an indexing system that allows a utility to change its overall rate level (and some or all individual rates) to reflect general cost changes in the economy or in the industry, but not the specific utility's actual costs. Under the index, a utility has an incentive to do better than the indexed normative costs. Typical components of such an index are national inflation (which generally represents cost increases) and a productivity factor (which generally represents cost decreases). Some incentive plans also include a provision for the sharing of earnings over a specified level between the utility and ratepayers, but such a provision presupposes continued tracking of earnings and the possible need for additional revenue requirement proceedings to determine those earnings. Many incentive plans also include some mechanism for ensuring service quality so that the incentive to control costs does not lead to poorer service.

B. Incentive Regulation in Maine; 35-A M.R.S.A. §§ 9101-9104; Commission Proceedings

Incentive regulation in Maine is governed by 35-A M.R.S.A. §§ 9101-9104 (Chapter 91), enacted in 1994. Section 9102 expressly authorizes an ”alternative form of regulation” that “must conform” to certain specified statutory provisions but “need not” conform to Chapter 3 of Title 35-A “to the extent that the provisions of chapter 3 require the use of rate-base, rate-of-return or any other specific form of regulation of the rates of a telephone utility.” One provision in particular in Chapter 91 is in controversy in this appeal. Section 9103(1) states that ratepayers may not be required during the term of the AFOR to pay more for “local telephone services” [1] than they would “under traditional rate-of-return regulation.”

The Commission has conducted two major AFOR proceedings. In 1995, it established the AFOR, an overall price cap or index known as the Price Regulation Index (PRI) and various pricing rules. *Public Utilities Commission, Investigation into Regulatory Alternatives for the New England Telephone and Telegraph Co. d/b/a/*

---

[1] Throughout, this brief will refer to “local” rates, the term used in the AFOR statute, although many of the orders quoted in this brief use the alternate term “basic.” “Local” or “local exchange” service includes calling to a customer’s home exchange and to other exchanges that are included in the customer’s “local calling area” or, as characterized in Chapter 204 of the Commission’s rules, “basic service calling area” (BSCA).

Calls to areas outside of a customer’s BSCA are “interexchange” calls, and the per-minute rates for those calls are “toll” rates or “retail toll rates.”

NYNEX, Docket No. 94-123, Order (May 15, 1995) (hereinafter, the *1995 AFOR Order*). Supp. Auth. At 3-96. The PRI included components for actual national inflation, for productivity at 4.5% annually, and a provision for extraordinary "exogenous" costs. The starting point for the PRI was established in a separate contemporaneous revenue requirement proceeding. *Pease v. New England Telephone and Telegraph Co. d/b/a/ NYNEX, Complaint Requesting Commission Investigation of the Level of Revenues Being Earned by New England Telephone Company and Determination of Whether Toll and Local Rates*, Docket No. 94-254, Order (May 15, 1995), Supp. Auth. at 97-158 (hereinafter, the *Pease Investigation*). Subsidiary pricing rules limited the amount of annual increases for "core nondiscretionary" rates (primarily local and retail toll rates) to the amount of the annual percentage change in the PRI, although decreases for those rates were not required if the PRI was negative. The Company could increase rates for "core discretionary" rates by any amount in its annual AFOR filings, but the total of all rates had to be within the limit set by the PRI. The AFOR also included a service quality index (SQI) to ensure continued high service quality. The Commission set the initial term of the AFOR at five years, "with a possible extension if ordered by the Commission."

During the initial phase of the AFOR, the PRI was always negative because productivity was always higher than inflation. Thus, no increases to retail toll or local rates occurred under the AFOR. As described below, however, there was an increase to local rates due to an external event. On an overall basis, prices declined by 12.5 percent during the first phase of the AFOR.

In December of 1999, the Commission opened an investigation (now the subject of this appeal) to determine whether to continue the AFOR and, if so, whether to modify it. Despite repeated requests by the Public Advocate, the Commission declined to conduct a revenue requirement proceeding in the course of this investigation. The reasons for that denial are explained in four orders and in Part VI of this brief.

In this Investigation, the Commission made several revisions to the AFOR. It found that the retail toll market was competitive and that market conditions would also limit the amounts that Verizon could charge for its discretionary services. Accordingly, the Commission decided that Verizon should be given pricing freedom for those services. The Commission also found that local service, directory assistance and operator services (for calling card and collect calls) were not competitive and capped those rates, except for the $1.78 increase to local rates to offset the reduction to access rates that Verizon was required to make pursuant to 35-A M.R.S.A. § 7101-B. The Commission abandoned the PRI, which included inflation and productivity components, that was part of the first phase of the AFOR. Because there is no explicit allowance for inflation under the revised AFOR, the practical effect of the price cap was to set the "productivity offset" equal to inflation. The Commission also found, however, that overall productivity was likely to continue at about same rate as during the first phase and that, because of this productivity, Verizon would be able to absorb expected retail toll losses that would occur in the competitive toll market, losses that would result in part from the reductions in access charges required by statute.

C. Access Rates in Maine and the Access Parity Statute

1. Access Rates and Their Relationship to Other Rates

Maine, like most states, has local service and interexchange service.[2] Local calls are carried by local exchange carriers (LECs); interexchange calls are carried by interexchange carriers (IXCs).[3] Within Maine, intrastate interexchange calls may be carried by competitive IXCs such as AT&T, MCI WorldCom or Sprint, or by Verizon Maine, which is both a LEC and an IXC.[4] IXCs use the networks of LECs (such as Verizon) for their customers to make or receive interexchange calls. In its role as a LEC, Verizon provides access services to its IXC competitors. Access rates are the wholesale equivalent of interexchange retail toll rates and are a major component of IXCs' costs. Retail toll rates and wholesale access rates charge retail and IXC customers, respectively, for the use of the facilities that carry interexchange calls. For these reasons, access rates are closely related to retail toll rates, particularly in a competitive market, where prices tend to vary with costs.[5]

---

[2] Local calling is provided as part of a customer's local rate. Retail interexchange service is for calls outside a customer's local calling area. Those calls normally incur per-minute toll charges. *See* further description in note 1 above.

[3] Many other carriers in Maine, including many of the major IXCs, have authority to provide local exchange service, but the Commission found in the *2001 AFOR Order* that there was relatively little local exchange competition in Maine, particularly for residential and small business customers.

[4] A customer may "pre-subscribe" to an interexchange carrier that will carry all calls that customer dials using seven digits (within Maine) and 10 digits (outside Maine). A pre-subscribed customer may access other IXCs by dialing that carrier's code or 800 number.

[5] *See* discussions in Part VII below and at pages 21-22 of the *2001 AFOR Order*, App. I at 38-39.

2. History of Access Rates in Maine; 35-A M.R.S.A. § 7101-B

Until recently, Maine had among the highest intrastate access and retail toll rates in the country. Under Chapter 280 of the Commission's rules, access rates were tied to and derived from retail toll rates. Retail toll rates were high in part because Maine, as a rural state, has relatively high per-customer costs, and in part because of a desire to keep local rates relatively low. In 1997, the Legislature enacted 35-A M.R.S.A. § 7101-B (the "access parity" statute), which requires each local exchange carrier to establish and maintain (at two-year intervals beginning on May 30, 1999) intrastate access rates that are no higher than the carrier's interstate access rates.[6] At the time the statute was enacted, Maine's intrastate access rates were in the neighborhood of 25 cents a minute and interstate rates were about six cents. Both the Legislature and the Commission were aware of many complaints by consumers about high in-state retail toll rates. Consumers complained in particular about the fact that in-state calls were much more expensive than out-of-state calls, even calls across the country.

3. Access Rate Proceedings

---

[6] Although Verizon cannot presently provide interstate retail interexchange (toll) services to Maine customers, it provides access service (i.e., the use of its Maine network) to interstate interexchange carriers such as AT&T, MCI WorldCom and Sprint. The "interstate access rates" referred to in section 7101-B are the rates that Verizon files with the Federal Communications Commission (FCC).

The intrastate access rates that, under the statute, must be "less than or equal to interstate access rates" are filed with and approved by the Maine PUC.

In the past 6 years the Commission has conducted three separate proceedings that addressed reduction of access rates in Maine. Each of these proceedings also considered whether it was necessary to increase other rates to offset some or all of the access rate reductions. The decisions in each of these proceedings is discussed in greater detail in Part VII below.

The first proceeding was a rulemaking that amended Chapter 280 of the Commission's rules. The amended rule required the Company to reduce its access rates by 20 percent. The Commission commenced the rulemaking in 1996, prior to the enactment of the 35-A M.R.S.A. § 7101-B. The rulemaking ended in June of 1997, after the enactment of the statute, but before its effective date and almost two years before the statute required any access rate decrease. The Commission denied the Company's request to increase other rates to offset the access rate decrease. *Public Utilities Commission, Amendment of Chapter 280, Provision of Competitive Telecommunications Services*, Docket No. 96-526, Order Adopting Rule (June 10, 1997) (hereinafter "*1997 Chapter 280 Rulemaking*").[7] Supp. Auth. at 280-305. The Company appealed and this Court affirmed the Commission's decision. *New England Telephone and Telegraph Co. d/b/a NYNEX v. Public Utilities Commission,* 1997 ME 222, 705 A.2d 706 (hereinafter, *NYNEX V. PUC).*

[7] The Public Advocate's brief has mistakenly cited this case as Docket No. 97-256.

On the same day that the Commission completed the rulemaking described above, it opened a further rulemaking and "Inquiry"[8] to address the access rate reductions required by newly enacted 35-A M.R.S.A. § 7101-B. *Maine Public Utilities Commission: Proposed Amendment to Chapter 280 to Achieve Parity With Interstate Access Rates by May 30, 1999*, Docket No. 97-319, Notice of Rulemaking; Notice of Inquiry (June 10, 1997). Subsequently, the Commission reopened the original AFOR case, Docket No. 94-123, to consider a stipulation presented by the participants in the Inquiry, including the Public Advocate. (hereinafter *1995 AFOR Investigation (Reopened)).* The stipulation agreed that Verizon should phase in a $3.50 increase to its local rates to offset some of the access loss that would occur in 1999. The Commission approved the stipulation in March of 1998.

The third proceeding to address the revenue losses due to access rate reductions required by the statute is the present AFOR investigation case, appealed by the Public Advocate. In the *2001 AFOR Order* in this case the Commission ordered an increase of $1.78 per month in local rates, or, in aggregate for all local ratepayers, $12.5 million per year, to offset an access rate reduction $14.5 million. The Commission also required Verizon to reduce its retail toll rates (or revenues) by at least $19.8 million per year.

---

[8] An "Inquiry" is a proceeding to obtain information or comment for the purpose of determining whether to commence an adjudicatory proceeding or rulemaking. An Inquiry cannot result in final binding action. PUC Rules, Ch. 110, §§ 105(h); 1201-1206.

IV. THE PUBLIC ADVOCATE, WITHOUT BASIS OR EXPLANATION, HAS ATTEMPTED TO DENY THE DEFERENTIAL STANDARD OF REVIEW APPLICABLE TO THIS APPEAL

The Public Advocate acknowledges that this Court normally defers to Commission decisions, stating that the Court gives "appropriate respect to the agency's expertise, particularly with respect to specialized questions of a factual or technical nature and discretionary judgments… ." The Public Advocate then states: "However, the question before this Court in this case is whether the Maine Public Utilities Commission has complied with the requirements of Title 35-A," but fails to explain why the Court's deference should suddenly disappear when the question is one of "compliance" with a statute the agency must apply. In fact, it is well established that this Court will defer to reasonable agency interpretations of laws that the agency must apply and enforce. *Town of Madison, Dept. of Elec. Works v. Public Utilities Commission*, 682 A.2d 231,234 (Me. 1996); *Public Advocate v. Public Utilities Commission,* 1998 ME 218 ¶5, 718 A.2d 201,203.

In the various orders issued in this case, it was necessary for the Commission to interpret the requirement of 35-A M.R.S.A. § 9103(1) that "ratepayers…may not be required to pay more for local telephone services as a result of the implementation of an alternative form of regulation than they would under traditional rate-base or rate-of-return regulation." The Commission interpreted that requirement based on its experience in applying both rate of return and incentive (alternative) regulation, its knowledge of the interrelationship between revenue requirement and rate design, and its judgment about the best means to ensure that incentives are effective. Similarly, it was necessary for the Commission to apply 35-A M.R.S.A. § 7101-B (the access parity statute) not only in light of other provisions of law that are subject to the "notwithstanding any other provision of law" language in section 7101-B, but also in light of its knowledge of the interrelationship among access, retail toll and local rates.

In addition to the question of interpreting the laws that the Commission must apply, this Court normally also will defer to reasonable discretionary decisions that the Commission makes under those laws. *New England Telephone & Telegraph Co. v. Public Utilities Commission*, 448 A. 2d 272, 279-288 (Me. 1982). The Public Advocate, however, attempts to make that discretion and deference disappear by the conclusory assertion that the question in this case is whether the Commission has "followed the law." The Public Advocate overlooks the fact that, absent an express and clear statutory mandate to conduct a revenue requirement case at a specific time (or ever), the Commission has considerable discretion in determining whether and when to conduct such a case, both within the context of general incentive regulation principles and under Maine statutes that govern alternative telephone regulation. The Public Advocate's facile transformation of a discretionary standard of review into a supposed pure question of "following the law" would only be credible if, for example, the AFOR statute expressly required the Commission to conduct a revenue requirement proceeding at five-year intervals.

The Public Advocate also fails to recognize that the Commission's decision to allow Verizon to recover most of the statutorily-required access rate reductions through an increase to local rates must also be viewed as a discretionary decision. The decision must be viewed in the contexts of (1) the Commission's previous decisions concerning offsets for access rate reductions; (2) the Commission's refusal to allow Verizon a similar offset for expected toll losses; (3) the Commission's experience and knowledge of Verizon's ability to absorb certain levels of losses in the light of existing revenues and competitive market forces; and (4) the Commission's findings concerning the interrelationship among access, retail toll and local rates and markets.

V. STRUCTURE OF THE ARGUMENT: THE PUBLIC ADVOCATE'S BRIEF HAS COMBINED TWO SEPARATE ISSUES

The Public Advocate's argument, paraphrased, appears be something like this: "The Commission acted unlawfully in allowing Verizon to increase basic rates to offset a reduction in access rates without conducting a revenue requirement proceeding as required by the AFOR statute." With all due respect to the Public Advocate's characterization of his own argument, the Commission believes that the Public Advocate is really making two separate arguments: first, that the Commission is prohibited by law from revising the AFOR at the expiration of its initial five and a half years without conducting a revenue requirement proceeding; second, that the Commission acted unlawfully in allowing Verizon to increase local rates to offset most of the expected decrease in access charges that were required by statute.

Regardless of what the Public Advocate is arguing, the Commission believes that these are two separate issues. The Public Advocate makes claims about the need to conduct a revenue requirement proceeding when the Commission is considering whether to extend and modify an AFOR that are quite unrelated to the access reduction and whether an increase to other rates was necessary to offset that reduction. The Commission also could have considered the access rate and offsetting rate issues in a separate proceeding (not connected to an AFOR proceeding), as it did on two prior occasions. The issue was considered in this case in part because of the coincidental timing of the revisions to the AFOR and the date that Verizon had to reduce access rates.[9] For these reasons, the Commission's brief will address each issue separately.

VI. THE PUC EXERCISED SOUND DISCRETION IN DENYING THE PUBLIC ADVOCATE'S REQUEST TO CONDUCT A REVENUE REQUIREMENT PROCEEDING

A. Introduction

In late 1999, the Commission opened an investigation into the questions of whether to extend the initial 5-year AFOR for Verizon and, if so, whether to modify it in any way. *Maine Public Utilities Commission, Investigation into Bell Atlantic-Maine and Alternate Form of Regulation,* Docket No. 99-851, Notice of Investigation (MPUC December 27, 1999). Throughout this case, the Public Advocate has requested the Commission to conduct a revenue requirement proceeding on the ground that such a proceeding is necessary to satisfy the requirement of 35-A M.R.S.A. § 9103(1). That subsection states:

---

[9] The coincidental timing was noted in the Order in this case (October 27, 2000) that extended the initial period of the AFOR for an additional half year. *See* App. ((cap i) at 250-251.

The Public Advocate, both to the Commission (at the briefing stage) and in the Notice of Appeal, claimed that the Commission provided inadequate notice that it would consider this issue in the AFOR proceeding. As discussed in Part VII below, however, the Public Advocate has presented no argument in support of that claim in his brief and therefore has waived the issue.

> For the period of the alternative form of regulation, which may not be less than 5 years nor exceed 10 years without affirmative reauthorization by the commission, ratepayers as a whole, and residential and small business ratepayers in particular, may not be required to pay more for local telephone services as a result of the implementation of an alternative form of regulation than they would under traditional rate-base or rate-of-return regulation.

This provision on its face does not require the Commission to conduct a revenue requirement proceeding at any time, whether at the beginning or, most importantly for this case, in the middle of an AFOR. The Public Advocate is therefore forced to argue that the *only* way to satisfy the requirement contained in section 9103(1), when the Commission is considering whether to extend and modify the AFOR, is to conduct a revenue requirement proceeding.[10] For this argument to succeed, the Public Advocate must establish that the Commission did not act within its sound discretion when it made several significant findings and determinations concerning the value of and need for a revenue requirement proceeding.

B. <u>The Commission Made Several Reasoned Findings and Rulings That Support Its Decision</u>

1. <u>A Revenue Requirement Proceeding at This Time Would Undermine the Incentives That Encourage Efficiency</u>

The Commission first determined that conducting a revenue requirement proceeding during the course of an AFOR might diminish the incentives

---

[10] As discussed in the Statement of the Case, the Commission did conduct a baseline revenue requirement case prior to the commencement of the AFOR in the *Pease Investigation*, Docket No. 94-254.

that are at the heart of incentive regulation. In the first order in this case that address the Public Advocate's request, the Commission stated:

> A primary purpose of the 1995 AFOR was to encourage the Company to pursue efficiency gains, using any legitimate means of revenue enhancement or cost control. The AFOR sought to use the potential enhancement of Bell Atlantic's financial performance as an incentive for the company to pursue those efficiency gains while simultaneously protecting basic ratepayers through pricing rules. ….
>
> The OPA would have us interpret the statute to mean that the effects of any efficiency gains that the Company was able to achieve during the initial term of the AFOR should prospectively be returned to ratepayers through an earnings investigation. The OPA requests us to re-initialize rates based on the current relationship between the Company's costs and revenues, as well as on an analysis of what a reasonable rate of return would be under current capital market conditions.
>
> We disagree with the OPA interpretation of the statute. Traditional revenue requirement rate cases have a tendency to undermine one of the basic purposes of incentive regulation: to break the link between costs and prices. A periodic resetting of rates to match costs, as under rate-of-return, cost-based regulation, sends a signal to a utility that efficiency gains will be used to benefit ratepayers on a going-forward basis (or, conversely, if the utility is inefficient, that those excessive costs, if undetected by regulators, might serve as the basis for increased rates).

Order Denying OPA Request (June 20, 2000) at 4-5, Supp. Auth. at 76-77.

In the second order addressing this issue, the Commission stated:

> As we explained in the June 20 Order, conducting a revenue requirement proceeding tends to undercut the efficiency incentive. Indeed, knowledge that a revenue requirement proceeding will occur could create a conflicting incentive to allow costs to rise toward the end of an AFOR period so that the test year used to establish the revenue requirement and rates will include those costs. … We do not agree with the proposition that ratepayers are entitled to all efficiency gains; such an approach surely diminishes or eliminates the efficiency incentive. [footnote omitted]

Order on Reconsideration (August 22, 2000) at 2, App. I at 88.

In connection with the issue of appropriate incentives, it surely is significant that the AFOR had been in effect for only five years, and that the Commission in this proceeding was not considering a new AFOR, but whether to extend the existing AFOR, and, if so, whether to order modifications. Section 9103(1) states that an AFOR may "not be less than 5 years nor exceed 10 years without the affirmative reauthorization by the commission…." In the *1995 AFOR Order* at 7, 88, Supp. Auth at 14, 75, the Commission, in establishing the AFOR initially, stated that it would be in place for five years "with a possible extension if ordered by the Commission." Even if the statute could be read as requiring a revenue requirement case and a matching of rates to that revenue requirement at the beginning of each new AFOR (and, of course, it says nothing of the kind), the Commission at the very outset of this AFOR established that it would last a minimum of five years and that it might be extended.

In the *Order on Reconsideration*, the Commission noted the "substantial flexibility" that section 9103(1) allows with regard to the duration of an AFOR. It also stated:

> The Public Advocate also apparently believes that, if the Commission extends the duration of an original AFOR or commences a new AFOR, the statute requires the Commission to begin anew in the same manner that it did for the initial period, i.e., by conducting a new revenue requirement proceeding and resetting rates based on the cost of service findings that the Commission makes in that proceeding. It seems more likely that in authorizing the Commission to establish an AFOR, the Legislature was using the term "alternative form of regulation" in a more general sense. There is no indication that the Legislature intended a series of separate, discrete plans, or that the Commission must set a revenue requirement, and new rates based on that revenue requirement, each time the Commission extends or establishes a new AFOR period.

Order on Reconsideration at 2, App. I at 88

At the conclusion of this case, the Commission noted that the mandate of section 9103(1) applies "for the period of the alternative form of regulation." The Commission stated:

> That determination is, of course, more difficult to make than the simplistic snapshot approach the OPA appears to urge; we doubt that the OPA's approach would satisfy the requirement of the statute. We believe we may apply our experience under both traditional and alternative regulation to make that determination, and we reaffirm the finding we made in the two prior Orders.

Order Granting Requests for Reconsideration; Order Granting And Denying Modifications (October 12, 2001) at 2, App. I at 93.

The Commission discussed the possibility that rates might be as low or lower than they would be under ROR regulation because of the incentives that exist under the AFOR when rates are not tied to costs. The Commission stated:

> During the entire 10-year (or longer) period, a telephone utility could be allowed to "over-earn" (as defined by the Public Advocate), suggesting that the Legislature is less concerned with a utility's earning level (or traditional "over-earning") than with the prices that Maine consumers must pay. In fact, the possibility that a utility may earn more than a rate of return that may be incorporated in a "starting point" for an AFOR serves as the primary incentive under alternative regulation for a utility to be efficient and reduce costs. Absent this incentive, it is possible that under traditional regulation a utility might earn a lower return but have higher prices than under incentive regulation. Although seemingly paradoxical, a higher return under incentive regulation could be accompanied by lower prices. Significantly, the Legislature did not require the Commission to ensure that a telephone utility not earn a greater return under an AFOR. Instead, the law requires the Commission to ensure that prices for basic local service be no higher under an AFOR.

Order on Reconsideration at 1-2, App. I at 87-88.

It might be argued that no harm could come from a revenue requirement proceeding at this time. In the first place, this argument overlooks the fact the one of the goals of the AFOR statute is to decrease regulatory costs. Revenue requirement proceedings are lengthy and expensive and, particularly in the case of the rate of return (cost of capital) issue, often highly judgmental.[11] It is, of course, possible that a revenue requirement proceeding at this point in time would show that Verizon's costs (per unit of output) had declined and that overall rates could be lower.[12] The Public Advocate's argument that there should be a revenue requirement proceeding at this stage of the AFOR necessarily suggests, if there are efficiency gains, they should be flowed through to ratepayers now. Such an approach, in the Commission's view, would be short-sighted. There may be a point, as the Commission acknowledged, when it would be possible to reflect AFOR-related efficiency gains in going-forward rates without significantly impairing incentives:

> As discussed earlier, rebasing rates to squeeze out earnings in excess of the allowed return arguably diminishes a major incentive of an AFOR, namely, the ability to retain the fruits of one's efforts to exceed the established productivity factor. On the other hand, it is questionable whether the incentive to attain greater efficiency will be lost if the utility is not allowed to continue to realize for the remainder of its regulated life whatever level of excess earnings it achieved under prior AFORs. Since, at the expiration of an AFOR, the utility has the right to seek relief if it is earning less than a fair return, it may be unfair to ratepayers to treat all overearning, no matter how great, as being permanently beyond the reach of the regulatory process.

Order Denying OPA Request at 7, App. I at 79.

Nevertheless, it is entirely possible that if the Commission took that action too soon, it would send a signal to Verizon (or any other utility under incentive regulation) that there's not much point in operating efficiently because the Commission will simply

---

[11] Subsection 2 of 35-A M.R.S.A. § 9103 states: "The costs of regulation of telephone utilities must be less under the alternative form of regulation than under rate-base or rate-of-return regulation."

[12] The Commission did review earnings reports provided by Verizon during the AFOR and found that its eaenings were "within reasonable boundaries." *Order Denying OPA Request* at 7. *See also FNOI* at 15; *2001 AFOR Order* at 8.

"grab" the short-term "fruits" for ratepayers. As a result, AFOR incentives could be impaired to such an extent that rates in the long term would be higher.

At only five years into the present AFOR, it is surely within the Commission's sound discretion to decide, in light of the purposes of incentive regulation generally and those the Commission discerned in the statute, that a revenue requirement case was unnecessary, and unlikely to serve the pubic interest and might counteract incentives.[13]

2. Local Service Rate Levels Are Not Higher Than They Would Be Under Rate of Return Regulation

As discussed above, the Commission noted the possibility, because of the AFOR itself, that rates could be as low or lower than they would be under ROR regulation. precisely because of the incentives that exist when rates are not tied to costs. In addition, the Commission noted that during the five years of the AFOR, Verizon's prices on an overall basis had declined by almost 10 percent[14] and that during a similar period, the FCC reported that consumer prices for all telephone services increased by slightly over 3 percent. The Commission also concluded that Maine's local service rates were affordable for the vast majority of the State's residents,

---

[13] In a case discussed in greater detail in Part VII below, *NYNEX v. PUC*, 1997 ME 222, 705 A.2d 706, this Court upheld the Commission's decision, in a rulemaking, to require the Company to lower its access charges by 20 percent without allowing it to increase other rates. That case at least establishes that the Commission is not required to look at revenue requirement every time it decides to do something that affects rates or revenues.

[14] Over the 5½ years of the initial phase of the AFOR (as extended for an additional six months) the decrease was 12.5 percent.

noting that Maine had the second highest telephone penetration rate (97.6%) in the country and a particularly high rate (94.5%) for low income households.

The Commission found specifically that local rates under the first phase of the AFOR were no higher than they would have been if rate or return regulation had continued. The Commission noted that the Public Advocate had placed great emphasis on the fact that "several" local rate increases occurred during the first five years.[15] The Commission found that although rates for local service had increased during the first five years of the AFOR, both of the increases were attributable to events "entirely external" to the AFOR. One was a modest increase due to expanded calling areas (BSCAs) for some local exchanges; the other was a larger increase of $3.50 to offset revenue losses due to the operation of the access reduction statute, 35-A M.R.S.A. § 7101-B. These increases would have been necessary under either form of regulation. Indeed, the Commission suggested that the $3.50 increase might have been higher under rate of return regulation.[16] *See Order Denying OPA request* at 8-9, App. I at 80-81.

---

[15] The Commission stated that there were only two increases to basic rates, and that the other "increases" were surcharges that were not part of the basic rate. *Order Denying OPA request* at 9.

[16] In discussing the stipulation that resulted in the $3.50 increase to basic rates as a "reasonable regulatory response to a legislative directive to reduce access charges," the Commission stated:

> In fact, the presence of the AFOR may have mitigated the potential effect that reduced access charges had on the basic rates increase, because Bell Atlantic had some intrinsic incentive to preserve the essence of the AFOR by entering into a stipulated result, rather than expending resources on a rate case proceeding. *Order Denying OPA Request* at 9, App. I at 81.

The Commission found that these rate comparisons were “evidence that BA’s level of earnings is (and will continue to be) within reasonable boundaries” and that it was “unlikely that BA is earning substantial excess returns.” *Order Denying OPA request* at 7.

3. <u>Local Rates Are to a Great Extent Determined by Rate Design Decisions and Policies</u>

Finally, the Commission relied on the fact that rate design is as significant an influence on local rates as are the costs of a utility (or overall rate levels that are allowed under an AFOR). Rate design is the process of allocating the overall allowed rate level among various categories of services and rates.

The Public Advocate argues that the Commission must make a “comparison” between local rates under rate of return and under an AFOR. The Commission agrees, but does not agree that section 9103(1) mandates any particular form of comparison. In the *Order on Reconsideration*, the Commission stated:

> …[S]ection 9103(1) states that the Commission must take some action to ensure that ratepayers are not paying more for basic local exchange service than they would have paid in the absence of an AFOR, but section 9103(1) does not specify the action that the Commission must take. Nothing in that subsection expressly requires a resetting of rates; such a requirement also cannot be necessarily implied. Nothing in the subsection precludes the Commission from ensuring the condition by means other than a revenue requirement proceeding, e.g., through the form of regulation itself or, as proposed in the Further Notice of Investigation in this case (June 26, 2000), through rate design.

Order on Reconsideration at 1, App. I at 87.

A telephone utility has at least three major service categories and numerous rates within those categories. Local service is one category. Interexchange service (calling outside the local calling area) is another. The interexchange category includes toll rates paid by retail customers and access (wholesale) rates paid by interexchange carriers. A third major category is discretionary services such as Call Waiting, Caller ID, and various enhanced services.

Under traditional regulation, the overall level of rates is established under pursuant to a revenue requirement finding. Under incentive regulation, it is established by an overall price level or price cap. In the first phase of the Verizon Maine AFOR, a revenue requirement finding established the initial overall level of rates, but annual changes in inflation and productivity (rather than periodic re-determinations of Verizon's actual costs) established subsequent overall rate levels.

Once the overall level of rates is established, a "rate design" establishes how that overall level is allocated among each of the major service categories and the numerous rates within each category. The Commission establishes a significant portion of the rate design for telephone utilities, either through the continuation or gradual modification of long-standing practice, through specific rate design decisions, or, in the case of the first phase of the AFOR, pricing rules for some services and pricing flexibility for others.

The Legislature also mandates certain rate design policies. Statutorily-required rate design plays a particularly important role in this case, as discussed in the access reduction – local rate increase issue at Part VII below.

In the *1995 AFOR Order*, the Commission addressed the fact that section 9103(1) was concerned with only local rates and not toll rates, despite its requirement to compare local rates under rate of return regulation (which ordinarily established a revenue requirement for all services) to rates under an AFOR. The Commission first determined that the term "local services" in section 9103(1) (as in other subsections of section 9103) really meant local exchange service and not some broader category of services. The Commission then ensured that the requirement would be met through a specific rate design decision that the Company could not increase local rates by more than the annual change in the Price Regulation Index (PRI) (inflation less productivity, plus or minus exogenous changes).[17] *1995 AFOR Order* at 9, Supp. Auth. at 16. The Legislature may have used a rate of return benchmark in section 9103(1), but the very fact that it is impossible to establish local rates pursuant to a revenue requirement case alone (because such a proceeding only establishes a total revenue requirement or "cost of service") strongly suggests that the Commission could satisfy the requirement of this subsection in more than one way.

With regard to the effect of revenue requirement and rate design on local rates, the Commission in this case stated:

> A revenue requirement proceeding can give us information about Bell Atlantic's total cost of service for all services. However, a revenue requirement proceeding tells us only the total cost of service and has only an indirect, if any, impact on rates for basic local service. Conducting a traditional revenue requirement case is not necessary for us to make the finding required by Section 9103(1), because that provision may be satisfied more directly through rate design. …
>
> Since local rates are a subset of all rates, and are established by allocating a portion of the overall revenue requirement, it follows that a revenue requirements case provides little useful information about future local service rates under ROR regulation versus under an AFOR.

---

[17] Because the PRI was always negative in the first five years of the AFOR, local rates never increased pursuant to the AFOR.

Order Denying OPA Request at 5, 7, App. I at 77, 79.

Because of historic rate design considerations that the Commission had discussed in the *1995 AFOR Order*, the Commission doubted that local rates would be reduced even if a revenue requirement case showed that overall rate levels should be reduced:

> [B]ecause our experience with telephone rate design persuaded us that basic rates were generally *underpriced* relative to other services, even if a traditional rate case justified an *overall* reduction in rates, *these* rates – i.e., basic rates for residential customers—would not be reduced. Stated simply, Bell Atlantic's overall level of earnings—the sole product of a revenue requirements case—would not, under any plausible set of assumptions, influence the price level for these basic services.

Id. at 6 Supp. Auth. at 13.

In the *2001 AFOR Order* the Commission did ensure reasonable local rates through a rate design directive, namely, that rates for local exchange service would be capped, except for the increase of $1.78 to offset the statutorily-required decrease in access rates, discussed in Part VII below.[18]

---

[18] The Public Advocate makes much of the fact that the Commission stated that the revised AFOR would "cap basic rates," but did not in fact do so. The Public Advocate is quoting the *Further Notice of Investigation*, which contained only a *proposal* to cap basic rates. As pointed out in the *2001 AFOR Order* at 16-17, App. I at 33-34, each party had an opportunity to present a case that advocated a result that was different from that proposed in the *FNOI*. Verizon convinced the Commission that the statutorily-required access revenue reduction should be offset with a basic rate increase. (Verizon was less successful with its argument that retail toll revenue losses should also be offset.) Otherwise, local rates are capped.

C. Other Provisions in Section 9103 Do Not Support the Public Advocate's Argument

The Public Advocate claims that two other subsections of section 9103 support his view that subsection 1 requires a rate case at this time. Subsection 5 states that the AFOR must ensure that charges for local service are "reasonable." This provision adds little or nothing to subsection 1. Under subsection 1, the benchmark is local rates under rate of return regulation. Under rate of return regulation (if not under an AFOR also), all rates must be "just and reasonable." 35-A M.R.S.A. § 301(2).

Subsection 6 addresses the opportunity of a telephone utility under an AFOR to earn a reasonable rate of return. However, the Public Advocate mischaracterizes that provision as stating that it "*prohibits* more than a fair rate of return on the investment needed to provide local service" and that Verizon is entitled "*only* to a reasonable opportunity to recover a fair return on its costs of providing local service." (emphases added) The implication of this argument is that if Verizon earns more than a fair return, the Commission must reduce its rates. Section 9103(6) in fact states:

> The alternative form of regulation must ensure that the telephone utility has, over the period of the alternative form of regulation, a reasonable opportunity to earn a fair return on the investment necessary to provide local telephone services.

This statement is nothing more than a reformulation of the law under traditional rate of return regulation. The Legislature obviously intended to carry over a similar legal requirement (which is constitutionally based) into incentive regulation. It states that a utility must have an *opportunity* to earn fair return. If a utility is inefficient or has bad luck, it might earn less. If it is efficient or has good luck, it might earn more. As discussed above, both of these risks are inherent in incentive regulation; contrary to the Public Advocate's argument, nothing in this provision sets a cap on earnings, and neither this provision nor the AFOR statute generally suggests that if a utility under an AFOR is earning in excess of a previously found rate of return, the Commission must adjust its earnings and rates.

In fact, as the Commission indicated in 1995, subsection 6 does not reinforce subsection 1; rather, the two subsections actually compete: "The statutory objective of affording NYNEX a reasonable opportunity to earn a fair return on its investment must be *balanced* with other objectives, such as those in sections 9103(1) and (4) that require reasonable rates and that ratepayers do not bear undue risks." *1995 AFOR Order* at 20-21, Supp. Auth. at 27-28 (emphasis added).

The Public Advocate does not claim that other subsections of section 9103 support his view of subsection 1. None of them supports his claim that the Commission erred. Indeed, many of the subsections (as well as the various separate sections outside of the AFOR Chapter, but incorporated in it by section 9102)[19] express policy goals that compete with each other and must be balanced.

---

[19] These include goals of achieving universal service, a "modern state-of-the art telecommunications network" that is "essential for the economic health and vitality of the State," and "affordable access " to "information services " that use computers and the telecommunications network. 35-A M.R.S.A. § 7101.

D. Cases Cited from Other Jurisdictions Do Not Support the Public Advocate's Argument

The Public Advocate relies on the fact that four other states during 2000 and 2001 conducted revenue requirement cases for telephone utilities that were under incentive regulation of some type. The Public Advocate did not provide a number for those states that have incentive regulation for their major telephone companies that did *not* conduct revenue requirement cases during that period. According to data from the National Regulatory Research Institute, 39 states have some form of rate cap or incentive regulation plans for their major telephone utilities. The Public Advocate also provided no information about whether any of these state commissions gave reasons for conducting revenue requirement proceedings, or whether these cases took place at the beginning of incentive plans (when utility commissions normally establish revenue-requirement-based starting points) or at other stages. In fact, only the New York and Minnesota cases involved renewals or modifications of incentive plans.

The Public Advocate places particular emphasis on a case decided by the Supreme Court of Utah. *Stewart v. Utah Public Service Commission*, 885 P.2d 759 (Utah 1994). The reason for this emphasis is not clear. The telephone utility, US West, was under a rather different form of "incentive" regulation than the Verizon Maine AFOR. The Utah Commission had apparently conducted a full revenue requirement case for US West because it has established an authorized rate of return. It is not possible to establish a rate of return without doing so. There were two incentives engrafted onto what otherwise appears to be traditional rate of return regulation. First, the PSC increased the allowed rate of return from 11.8%, the amount it found to be reasonable, to 12.2% to induce US West to make "discretionary" investments in Utah. Second, above the 12.2% level, the PSC ordered a sharing of earnings between the Company and ratepayers, with increasing amounts going to the company as earnings increased up to 17%.

The Utah Supreme Court reversed for a number of reasons, including a notice deficiency. The Court ruled that the Utah statute authorizing incentive regulation required that rates continue to be based on cost-of-service principles. Essentially, the Court found that the return allowed under the incentive plan was excessive. The Utah case does not appear to have relevance to whether the Maine Commission is required to conduct a revenue requirement case in the middle of an AFOR that regulates prices, not costs and not earnings.

E. Productivity Implicit in the Revised AFOR Addresses Other Arguments Raised By the Public Advocate

The Public Advocate also suggests that the Commission might have been able to satisfy the requirement of section 9103(1) in some alternative manner: for example, by adopting a productivity index such as that included in the initial five years of the AFOR. This argument overlooks the fact that, for local rates, the Commission did include an implicit productivity index equal to inflation (Verizon cannot raise local rates even if inflation occurs). In addition, for retail toll rates, the Commission in effect established the same productivity as the index under the first phase of the AFOR by finding that a similar level of productivity gains was likely to continue in the future and that Verizon therefore should be able to absorb the expected level of retail toll revenue losses.

The Public Advocate complains in particular about one cost-related issue it believes the Commission should have addressed in a revenue requirement proceeding: the savings that Verizon may have realized as a result of the Nynex-Bell Atlantic merger. The Commission did not expressly address the merger savings in this case. Nevertheless, in the merger case itself, *New England Telephone and Telegraph Co. and NYNEX Corp., Proposed Joint Petition for Reorganization Intended to Effect the Merger with Bell Atlantic Corporation,* Docket No. 96-388, Order (Part II) (*Merger Order),* the Commission stated that a merger "is an example of the cost-reducing activity that the AFOR was designed to encourage…." The Commission also noted that "capture at this time" of the merger savings "would significantly impair the efficiency incentives under the AFOR." *Merger Order* at 14, Supp. Auth. at 175 (MPUC February 6, 1997).[20]

In this case, after reviewing conflicting evidence from witnesses who attempted to quantify productivity, the Commission found that productivity gains were likely to continue in the second phase of the AFOR at approximately the same level as in the first phase. Necessarily, therefore, if the Bell Atlantic-NYNEX merger savings were included in the productivity recognized in first phase, they are also included in the productivity recognized in the revised AFOR. The Commission did not adopt a specific productivity factor in the revised AFOR. It did, however, find that Verizon would be able to absorb expected retail toll revenue losses because of continued levels of productivity.

[20] The Commission apparently was also concerned with the longer term, stating that it saw "no reason…to weaken the [AFOR] incentives…by requiring a flow through of some of the merger's benefits over the next several years." *Id.*

Verizon estimated that it would suffer toll losses in the range of $19.8 million to $51 million.[21] In other words, through lower retail toll rates, Verizon Maine ratepayers will benefit directly from the productivity gains under the revised AFOR, including productivity gains resulting from the merger.

F. Conclusion

In the *1995 AFOR Order*, the Commission stated:

> Plainly, at the conclusion of five years, it will not be possible with certainty to determine whether the AFOR was more successful than continued ROR, for the simple reason that ROR was not continued, and its results can never be known with certainty.

The Commission then quoted the 1995 brief of the Commission Advocacy Staff:

> The Commission should judge how well an ARP has worked in general terms by the following criteria: universal service should be up, quality of service maintained or improved; and prices down. … If exchange rates remain steady or decline and toll rates fall, and the Company has avoided the customer service penalties developed as part of the [Staff Alternative Regulatory Plan], then the future will be better than the past.

The Commission concluded:

> [I]f in fact the measures of success that Staff proposed actually occur, and, at the same time, NYNEX earns a reasonable return on its investment, it is likely that the Commission, when the plan is reviewed, will find that it has been successful.

1995 AFOR Order at 36-37, Supp. Auth. at 43-44.

---

[21] The Commission has ensured that at least the lesser amount of these projected losses will occur by requiring Verizon to reduce its retail toll rates or revenues by $19.8 million by the end of 2002.

By comparison to the estimated toll revenue losses, Maine's share of the estimated merger savings was about $12.6 million. *1995 AFOR Order (Reopened)* at 9.

The expectations of the Commission (and its advocacy staff) have been largely realized. The local rate increase and the toll rate decreases that were greater than expected are due to an event (the access parity statute) that was not anticipated in 1995 and that was external to the operation of the AFOR.

An overall perspective about the Commission's decision in this case strongly suggests it was not necessary for the Commission to conduct a revenue requirement proceeding. Despite the Public Advocate's claim that the Commission has "materially changed the terms of the AFOR,"[22] as a practical matter, little has changed.

Under the pricing rules (and declining PRI) of the first five years of the AFOR, local rates under the AFOR were capped. Under the revised AFOR, the Commission found that local exchange service competition has not sufficiently developed and ordered that local rates remain capped.[23]

Under the pricing rules (and declining PRI) applicable during first five years of the AFOR, Verizon was not permitted to increase toll rates. In fact, Verizon's retail toll rates decreased markedly, primarily due to the access statute and its effect on the competitive retail toll market. Under the revised AFOR, the Commission granted Verizon pricing freedom with respect to retail toll rates because it found that the market

[22] Public Advocate brief at 17 n. 18.

[23] The increase of $3.50 to local rates during the first phase of the AFOR and the $1.78 increase ordered in this case are not due to the operation of the AFOR but because of required access rate reductions.

for retail toll is fully competitive and that rates will be regulated by that market.[24] The Commission expects that retail toll rates will continue to decline during the revised AFOR.[25]

Under the first phase of the AFOR Verizon was permitted substantial pricing flexibility with respect to discretionary services. The Commission has expanded that pricing flexibility somewhat. The Commission found, however, that because of the nature of the demand for those services (elastic) and other market considerations, Verizon has only limited ability to raise those prices. *2001 AFOR Order* at 11-12.

Finally, under both phases of the AFOR the surcharges for calling card and collect calls ("operator services") and rates for directory assistance have been capped. The Commission considers these to be essential adjunct services.

The Court should find that the Commission carefully considered the alternatives and, in its sound discretion, made a reasoned and reasonable decision that a traditional revenue requirement case was not necessary at this time.

---

[24] Of course, access rates, which have a substantial influence on retail toll rates, remain strictly regulated by the access parity statute.

[25] As noted above, the Commission required Verizon to show that its retail toll rates or revenues have declined by $19.8 million by December 31, 2002, the lower end of Verizon's estimate of toll revenue loss. Under section 7101-B(3) the Commission also has the obligation to ensure that access rate reductions flow through to retail ratepayers and may order all interexchange carriers to reduce their retail toll rates.

VII. THE COMMISSION EXERCISED SOUND DISCRETION IN ORDERING AN INCREASE TO LOCAL RATES TO OFFSET THE LOSS IN ACCESS REVENUES; THERE IS NO STATUTORY BAR TO RAISING LOCAL RATES

A. Introduction

The Public Advocate argues that the Commission acted unlawfully in ordering a local rate increase to offset the access rate reductions that Verizon was required by law to make on May 30, 2001. Initially, the Commission notes that both before the Commission and in the Notice of Appeal, the Public Advocate raised issues concerning alleged deficiencies of notice and process in the way the Commission addressed this issue in this case.[26] The Public Advocate provided no argument in his brief as to these matters and has therefore waived those issues.[27]

In 1997, the Legislature enacted 35-A M.R.S.A. § 7101-B, entitled "Access rates." Subsections 1 and 2 of this section state:

> **1. Definitions.** As used in this section, the term "intrastate access rates" means rates that a telecommunications service provider pays for access to a local exchange carrier's facilities and services in order to provide intrastate interexchange service.

---

[26] The Public Advocate claimed that the Commission provided inadequate notice that it would consider this issue in the AFOR proceeding and that the Commission denied due process to the Public Advocate by admitting evidence concerning revenue losses. The Commission addressed the notice issue in the *2001 AFOR Order* at 16-17, App. I at 33-34, and in the *Order Granting/Denying Modifications* (October 12, 2001) at 2-3, App. I at 93-94. The Commission addressed the evidentiary issue during the hearings at Transcript E-135-E137 and E191-E192.

[27] The Public Advocate's Statement of Facts contains a statement "What came next was a surprise," followed by a short passage describing the filing of rebuttal testimony by Verizon that addressed access and toll revenue losses, but the brief contains no argument.

> **2. Access rates.** Notwithstanding any other provision of law, the commission by May 30, 1999 shall establish and every 2 years reestablish intrastate access rates that are less than or equal to interstate access rates established by the Federal Communications Commission.

Pursuant to subsection 2, Verizon reduced its intrastate access rates to the same level as its interstate rates on May 30, 1999 and on May 30, 2001.

As described in the Statement of the Case (Part III) above, between 1997 and 2001, the Commission addressed access rates and access revenue losses in a variety of ways. Almost two years prior to the date that section 7101-B required any reductions to access rates, the Commission in a rulemaking required NYNEX (one of Verizon's predecessors) to reduce its access rates by 20 percent. The Commission on that occasion prohibited the Company from increasing any other rates to offset the access loss. *1997 Chapter 280 Rulemaking,* Order Adopting Rule (June 10, 1997). NYNEX appealed the Commission's decision and this Court affirmed. *NYNEX v. PUC,* 1997 ME 222, 705 A.2d 706.

For the 1999 statutorily-required access rate reduction, the Commission allowed the Company to increase local rates. The Company estimated that 1999 access rate decrease would be $ 56.4 million a year. Pursuant to a stipulation that the Public Advocate joined, the Commission ordered an increase in local rates of $3.50 (phased in over a 12 month period). The Company estimated that the aggregate annual increase to local rates was $27.5 million. *1995 AFOR Investigation (Reopened)*, Docket No. 94-123, Order at 7-8, Supp. Auth. at 206-207 (March 17, 1998).[28]

For the 2001 reduction, the Commission ordered an increase of $1.78 a month to local rates, or an aggregate annual amount of $12.5 million, to offset access revenue losses that Verizon estimated would be $14.5 million.[29] At the same time, the Commission denied Verizon's request to increase local rates even further to offset anticipated retail toll losses that Verizon estimated could range from $19.8 to $50 million.

B. <u>The Commission Exercised Sound Discretion</u>

The Public Advocate argues that because this Court in *NYNEX v. PUC* upheld the Commission in the appeal from the 1997 rulemaking, the Commission in this case could lawfully have ruled that Verizon would not be permitted to offset any of the access loss. Even the Public Advocate's characterization of this argument highlights the fact that the Commission must have some discretion in whether to allow or not allow an offset. Although the Court did not expressly characterize the Commission's decision as discretionary, the Court's decision surely does not stand for the proposition that the Commission *cannot* offset an access revenue loss. The Court also upheld the

---

[28] Although the Stipulation was filed in Docket No. 97-319, the Commission approved it in reopened Docket No. 94-123.

[29] The Commission decided there would be some growth in the amount of access sold because of the lower prices. Verizon actually reduced its access *rates* by $14.5 million based on historic levels of usage, but, because of demand growth, the Commission found that its access *revenue* loss would be $12.5 million.

Commission's choice of using a rulemaking, rather than a revenue requirement proceeding, to reduce access rates.

It is possible that the Commission might have had discretion in the present case to rule that Verizon could not offset the access loss, but the Commission exercised its discretion in another direction. The access revenue loss in this case ($12.5 million) is considerably greater than that ordered in the 1997 rulemaking (estimated by the Company at $5.3 million). Because of that difference, it is also possible that the Commission might *not* have had discretion in this case.[30]

In any event, although the Commission denied any recovery to the Company in the 1997 rulemaking, under the operation of the first phase of the AFOR the Company was free, in each annual AFOR filing, to make up for the lowering of one set of rates by raising other rates, as long as its overall rate level was less than the amount allowed by the PRI (the price index), and as long as the Company followed other applicable pricing rules. Those rules prohibited increases to local or retail toll rates if the PRI was negative (as it was throughout the first phase of the AFOR), but allowed increases to discretionary services. The Company in fact did subsequently include the access decreases in its annual AFOR filing, thereby permitting it to increase other rates.[31]

---

[30] The Court in *NYNEX v. PUC* noted that the Commission's action "undoubtedly affects NYNEX's opportunity to earn a fair return." 1997 ME 222, ¶7,705 A.2d 706, 708.

[31] *See* Bell Atlantic-Maine, *Alternative Form of Regulation Filing (1998 Annual AFOR),* Docket No. 98-680, Order Approving Filing (November 5, 1998); 1998 Annual AFOR filing, Cover letter dated September 1, 1998 and "1998 Administrative Filing Addendum to 1997 Annual AFOR." Supp Auth at 259-279. The Company could have included the access rate reductions in the 1997 filing, but apparently chose not to do so

The 1999 access reduction, the first one required by the access parity statute, was considerably larger than the 1997 rulemaking reduction. The Company estimated access losses at $ 56.4 million. As described in the Statement of the Case, the Commission opened a separate proceeding (the Inquiry in Docket No. 97-319) to address this loss. Following many months of negotiation, the parties, including the Public Advocate, presented a stipulation that included a phased-in $3.50 increase to local rates. *1995 AFOR Investigation (Reopened)*, Docket No. 94-123, Order (March 17, 1998) Supp. Auth. at 199-227.

As noted in the *Order Denying OPA Request* in this case, the access parity statute was not anticipated when the AFOR was implemented and “the parties to the Stipulation estimated the decrease in the Company’s revenues from the access charge reduction significantly exceeded the additional local service revenues generated.” *Order Denying OPA Request* at 8, App. I at 80. The Company (as in the case of the 1997 rulemaking access reduction) in theory could have made up for reduced access and toll revenues in the succeeding annual AFOR filings. However, there was a legal barrier (the aforementioned AFOR pricing rule) against raising either local or retail toll rates, and a significant practical barrier against raising rates other than local rates.

In 1998, the parties, including the Public Advocate, recognized that it was difficult for the Company to increase rates for discretionary services by an amount sufficient to cover the access losses. The parties also recognized that it was not possible to make

---

because its own appeal was pending. The Commission took no action that would have prevented the Company from including the reductions in the 1997 filing.

up the lost revenue by increasing retail toll rates. As explained in the *2001 AFOR Order* at 21-22, App. I at 38-39, and in Part III(C)(1) above, access rates have a significant effect on rates in the competitive retail toll market. Access rates are the wholesale rates paid by interexchange carriers (IXCs) for the use of Verizon's network and are a significant portion of the IXCs' costs. In a competitive market, prices generally are closely related to costs. As costs fall, so do prices. As a participant in the competitive interexchange (toll) market (as well as the wholesale provider of access services to its interexchange competitors), Verizon must respond to the rates of its competitors.

The Commission has found that the purpose of section 7101-B is to lower retail toll rates:

> The purpose of the legislation was to encourage IXCs (including Bell Atlantic and other ILECs and competitive LECs that provide interexchange service) to reduce their in-state long distance rates, which were relatively high compared to interstate long distance rates and to intrastate long distance rates in other states.
>
> *Order Denying OPA Request* at 8, App. I at 80.

In addition to the expected operation of the competitive market, the Legislature in effect has required IXCs to decrease their retail toll rates as a legal condition of lower access rates. Subsection 3 of section 7101-B states:

> **3. Consumer rates.** If the commission finds that effective competition in the intrastate interexchange market does not exist, the commission shall require all persons providing intrastate interexchange service to reduce their intrastate long-distance rates to reflect net reductions in intrastate access rates ordered by the commission pursuant to subsection 2.

There are only three major categories of retail rates: discretionary, toll and local. If it is not possible to increase rates by a sufficient amount for the first two categories, the only remaining category is local. Accordingly, the parties, including the Public Advocate, agreed in the 1998 stipulation that it was necessary for the Commission to waive the AFOR pricing rule that prevented increases to local rates and to raise those rates by $3.50.[32]

In the present case, Verizon presented evidence that the access rate reduction required on May 30, 2001 would cause it to lose $14.5 in access revenues (assuming no increase in the volume of sales) and between $19.8 million and $50 million in retail toll. Under the revised AFOR, Verizon faced circumstances that were essentially the same as those in 1998-99. Although the form of the AFOR had changed and many of its pricing rules eliminated,[33] Verizon was still faced with a legal barrier against raising local rates (because they remain capped under the revised AFOR) and practical, market-related impediments to raising anything else. In this case the Commission exercised its discretion

---

[32] The 1998 Stipulation, like most stipulations filed with the Commission, stated that it was "shall not operate as precedent in any other Commission proceeding on such issues, nor be construed as an agreement by any party as to any matter of fact or law raised in this proceeding." Lest the Public Advocate argue in reply that the Commission should not now recall his participation in the 1998 Stipulation, the first clause of that sentence obviously means that acceptance of the stipulation by the Commission should not be considered to be Commission precedent, i.e., binding on the Commission in the future. Whatever the second clause is intended to accomplish, the fact remains that the Public Advocate agreed to the end result that local rates would increase by $3.50. The Public Advocate is surely free to take an inconsistent position under similar circumstances in a subsequent proceeding, but the Stipulation clause just as surely does not preclude the Commission or any other person from noticing that inconsistency.

[33] Under the revised AFOR, there is no longer a PRI under which Verizon can make up for lowered rates in one category by increasing rates to other categories, but Verizon has complete pricing freedom for all rates other than local and operator service and directory assistance surcharges.

by allowing Verizon to increase local rates by $1.78, an action that was fully consistent with the action it took in anticipation of the 1999 access decrease.

Simultaneously, the Commission exercised its discretion to deny Verizon's request to raise local rates even further in order to offset the retail toll revenue losses that Verizon estimated would be between $19.8 million and $50 million. The reasons for this refusal are stated in detail at pages 18-24 of the *2001 AFOR Order*, App. I at 35-41. The Commission found that Verizon should be able to absorb the retail toll losses through continued increases in productivity. It also found that access rates have an indirect effect on the retail toll market, particularly on toll *rates*, but that other factors have a considerable influence on Verizon's retail toll *revenues*, including Verizon's market share; and that Verizon has some degree of control, through pricing and marketing, over its market share. The Commission also noted that the losses will not occur immediately, and their amounts are far from certain.

The Commission also required Verizon, by the end of 2002, to show that it had reduced retail toll rates or revenues by $19.8 million. By contrast, the increase to local rates amounts to $12.5 million annually. The net annual benefit to Verizon Maine local and retail toll customers collectively is at least $7.3 million, and the benefit will be greater if retail toll reductions are more than the minimum amount estimated by Verizon.[34] Whatever the ultimate level of net aggregate customer benefit, the average customer bill will decrease.

---

[34] In addition to retail toll rate reductions for customers of Verizon, customers of other interexchange carriers should experience toll rate reductions because of the

The Public Advocate argues "if the FCC's price is about right, the revenue 'lost' under § 7101-B is simply excess revenue." The Public Advocate apparently assumes that because section 7101-B requires a local exchange carrier's intrastate access rates to be equal to (or less) than its interstate rates established by the FCC, *intrastate* rates must be "about right" as long as interstate rates are "about right." Furthermore, if interstate rates are reduced, then the difference in intrastate revenues between the old and new "about right" intrastate rates is "excess," as in "not needed." It follows, of course, from this argument, that a local rate increase was not necessary.

This argument ignores the obvious fact that if a utility's total rates are set "about right" (whether under rate of return or incentive regulation) and one subset of rates is reduced without raising another rate to compensate for lost revenues, the remaining total rates will no longer be "about right."

The phraseology of the Public Advocate's argument suggests that he doesn't even know "*if* the FCC's price is about right." (emphasis added). The Public Advocate does not attempt to define what an "about right" interstate access rate might be. Perhaps the Public Advocate believes he is making an argument about cost-based rates, but in fact interstate access rates (and, by definition, the intrastate rates derived from them) are not cost-based because of federal rate design policy decisions.

The Maine access parity statute requires LECs in Maine to set intrastate access rates paid by intrastate IXCs at the same (or lower) rate as those carriers' interstate

---

access rate reduction and the effect of that reduction on the competitive retail toll market.

access rates paid by interstate IXCs. However, the interstate access rates paid by interstate IXCs are for only a portion of the costs assigned to the interstate jurisdiction.[35] Interstate costs are allocated as a matter of rate design between access rates paid by interstate interexchange carriers,[36] flat monthly end-user charges paid by local end-user customers, and other interstate services provided by local exchange carriers. There is no obvious cost basis for making this allocation; it is essentially a policy decision. A wide range of interstate access rates could be "about right."

Intrastate costs, which are definitionally different than interstate costs,[37] are also subject to rate design or policy decisions that allocate total rates among access, retail toll and local ratepayers. In Maine, the allocation is not cost-based, particularly since the access parity statute establishes the access rates portion by reference to another agency's rate decisions for a different jurisdiction. The Legislature had no intent to establish cost-based intrastate access rates. Rather, it established intrastate access rates that were the same as interstate access rates, with the ultimate intent that intrastate retail toll rates fall to interstate levels.

---

[35] Interstate and intrastate services (access, as well as other services) use the same facilities. The total cost of those facilities is allocated between the interstate (federal) and intrastate (state) jurisdictions by a process called "separations." 47 U.S.C. § 221(c); 47 C.F.R. Part 36.

[36] In addition, Verizon does not file interstate access rates with the FCC that specifically apply to Maine. It files a single set of rates for a group of states in which it provides service, thereby averaging the costs included in those rates despite widely varying costs between urban and rural states.

[37] As noted above, a portion of total costs are assigned to states pursuant to the separations process. Interstate and intrastate costs are seldom, if ever, equal.

There is nothing to suggest that the interstate access rate is "about right," or, in particular, that such a rate results in an "about right" rate on the intrastate side. The whole concept of "excess" intrastate access revenues is totally fallacious.

E. The Public Advocate's Arguments That Other Statutes Prohibit an Increase to Local Rates Are Unsound

Based on two statutory provisions, the Public Advocate claims in effect that the Commission's action in ordering the local rate increase was unlawful. The Public Advocate apparently did not believe so in 1998, hen both of these provisions were in effect and he joined in the Stipulation that allowed a local rate increase of $3.50.

The Public Advocate complains that that the *2001 AFOR Order* did not adequately address the requirement of section 9103(4) that the AFOR must:

> provide adequate safeguards to ensure that risks associated with the development, deployment and offering of telecommunications and related services offered by the telephone utility, other than local services, are not borne by the local telephone service subscribers of the telephone utility.…

The Public Advocate complains in particular that increasing local rates shifts the risk of interexchange services (access and retail toll) to local ratepayers. The Public Advocate is apparently unaware that in the *1995 AFOR Order* at 13-16, Supp. Auth. at 20-23, the Commission interpreted this provision as requiring safeguards for both local and interexchange service customers (even though the statute itself refers only to local subscribers), primarily on that ground that both services jointly use many of the same facilities. As interpreted, the Commission must provide adequate safeguards to local and retail toll subscribers against the risks presented by non-local and non-toll services.

To deviate from the literal words of subsection 4 and make this interpretation, the Commission specifically relied on and made the finding required by the introductory paragraph of section 9103, which states:

> Unless the commission specifically finds that the following objectives are not in the best interests of ratepayers, the commission shall ensure that any alternative for of regulation it adopts under section 9102 is consistent with the following objectives.

It is, of course, impossible to argue that a rate design decision that favors retail toll customers over local customers violates this provision in any way, once it has been interpreted to apply the required safeguards to local and interexchange customers collectively, particularly when the minimum decrease required for retail toll rates or revenues ($19.8 million) exceeds the increase to local rates ($12.5 million) by $7.3 million.[38]

The *1995 AFOR Order* also interpreted the word "risks" that, under section 9103(4), cannot be borne by local or retail toll ratepayers to apply only to "entrepreneurial risks." The Order defined "entrepreneurial risk" as the risk, borne by the utility, that "sufficient sales will not occur, that costs will be higher than expected, and that it will not earn a fair return on its investment." The Commission distinguished "entrepreneurial risk" from "the burden of bearing the cost of an investment." *1995 AFOR Order* at 15, Supp. Auth. at 22. Under the *1995 AFOR Order* and section

---

[38] If the Commission had not interpreted section 9103(4) in this way, the requirement of this subsection might still have to yield to the conflicting policy goal of section 7101-B(2) because of that section's "notwithstanding any other provision of law" clause, discussed below.

9103(4), Verizon's shareholders bear "entrepreneurial risk." Investment risks are normally borne by ratepayers. *See Casco Bay Lines v. Public Utilities Commission*, 390 A.2d 483, 489-90 (Me. 1978). The "entrepreneurial risk" of providing access services surely does not include the risk of losing revenue because a statute requires rate decreases.

Although the Commission in this case decided that Verizon could recover the access revenue losses that were caused directly by the operation of the access parity statute, it also decided that it could not recover retail toll losses. These decisions are fully consistent with the discussion in the *1995 AFOR Order* concerning risk and the distinction, under subsection 4, between "entrepreneurial" and "investment" risks. As discussed above, the Commission found that Verizon had a significant degree of control over its sales volumes and ultimate level of retail toll revenue loss; that control can fairly be described as "entrepreneurial."

The Public Advocate next argues that 35-A M.R.S.A. § 7303(2) prohibits the Commission from increasing local rates. Section 7303(2) states that the Commission must "preserve traditional flat rate local telephone service at as low a cost as possible." Section 7101-B states that intrastate access rates must be equal to or lower than interstate access rates "notwithstanding any other provision of law." The Public Advocate, apparently in an attempt to deflect the "notwithstanding" language, argues that there is "no conflict" between section 7101-B and section 7303(2). The Public Advocate appears to be arguing that section 7101-B requires Commission to lower access rates, that section 7303(2) requires the "lowest possible" local rates, and that nothing on the face of either statute expressly states that the Commission cannot do both. In practical effect, the Public Advocate is interpreting the section 7303(2) as prohibiting *any change* to local rates rather than as a requirement that the Commission establish local rates that are as low as "possible" in light of other regulatory (and Constitutional) requirements.

At one level, it is possible to "agree" with the Public Advocate that there is "no conflict" between these two sections: just as nothing in either statute states that the Commission cannot satisfy both mandates, nothing in section 7303(2) expressly prohibits a rate increase. There is also no conflict at another level: as noted above, the Commission believes the phrase can and should be read to mean rates that are "as low as possible" in light of other regulatory requirements, including the absolute mandate of section 7101-B, which must prevail over the relatively flexible policy ("as low as *possible*") in section 7303(2). When applying the two statutes to a situation in which the Commission must actually establish rates, the Commission may need to resolve a conflict between two statutory rate design goals that compete for a finite amount of dollars.[39] Under normal well-established ratemaking principles, whether under traditional or incentive regulation, it is not always possible to satisfy the access parity statute and also leave local rates unchanged, as the Public Advocate recognized in 1998.

---

[39] Prior to the enactment of section 7101-B, the Commission had interpreted section 7303(2) as a rate design "directive" that would favor local rates over other rates, and would limit the circumstances under which local rates could be increased. *See 1995 AFOR Order* at 8-9. Section 7101-B, particularly the "notwithstanding" clause, necessarily alters that interpretation.

The "Notwithstanding any other provision of law" language in section 7101-B(2) either removes or resolves any conflict, however. That language states that if a conflict does exist between the access rate parity requirement and another policy (because it is not reasonably possible to follow both policies simultaneously), the conflict must be resolved in favor of the access parity requirement. To the extent that there was conflict between the two policies, the Commission followed the law in resolving it.[40]

VIII. CONCLUSION

The Maine Public Utilities Commission requests the Court to find that the Commission, in the exercise of sound discretion, reasonably denied the request of the Public Advocate for a revenue requirement proceeding under all of the circumstances present in this case, including: that the Commission was considering whether to extend or modify an AFOR that was only five years old; that a revenue requirement proceeding at this time would diminish the incentives that are part of an AFOR; and that rate design has as great an influence on local rates as total allowed rates, or revenue requirement.

The Commission also requests this Court to find that the Commission acted lawfully and within its discretion in deciding that it was reasonable to allow Verizon to

---

[40] The Commission also did so in 1998 when it accepted the stipulation that resulted in the $3.50 increase to local rates. If, notwithstanding the "notwithstanding" language of section 7101-B, the Legislature believed that the Commission had violated the "lowest possible rate" requirement of section 7303(2), it could have taken corrective action. Where an agency makes a "reasonable and practical interpretation of a statute" (or interrelated statutes), and the Legislature is aware of the agency's interpretation, its failure to act is evidence of its acquiescence in the interpretation. *In Re: Spring Valley Development*, 300 A.2d 736, 743 (Me. 1973). In this instance the Commission informed the Legislature of its actions in its 1998 Annual Report to the Legislature.

offset a statutorily-required access rate reduction, in light of: the Commission's findings about the relationship between access rates and the retail toll market; its refusal to allow Verizon to offset retail toll losses, the requirement that Verizon decrease retail toll rats (or revenues) by $19.8 million, an amount that exceeds the local increase by $7.3 million; and 35-A .R.S.A. § 7101-B (the access parity statute), which establishes priority of the policy in that statute over other statutory rate design policies.

For all of these reasons, the Commission requests this Court to deny the appeal of the Public Advocate and affirm the Commission's decisions.

Dated: February 22, 2002

Respectfully submitted,

Peter G. Ballou
Deputy General Counsel
Bar No. 1821